December 2022

Creating tomorrow, together:
Our final methodology for PR24

Appendix 2
Water trading incentive

Ofwat

About this document

This appendix relates to decisions on the water trading incentive as set out in Chapter 3 of our Final Methodology. It sets out our policy on the water trading incentive for PR24 and looks ahead to changes that we intend to bring in from PR29.

We set out why we are retaining the current water trading incentive unchanged for PR24. We explain how it works and how we have taken account of stakeholder views in our final methodology.

We further set out why we consider that the water trading incentive will need adapting from PR29 and why we are setting this out now to support investment decisions that will need to be made in the 2025–30 period. We set out our intended broad approach to the water trading incentive that will come into effect from 2030 and how this will affect decisions and actions made by companies and investors in the 2025–30 period.

Contents

1. Introduction

This appendix relates to decisions on the water trading incentive as set out in Chapter 3 of our Final Methodology.

Water trading is one option available to companies when they consider how to make sure they have adequate water resources to meet the needs of their customers. We provide an incentive for companies to trade water with each other as it may offer an efficient way to contribute to their provision of adequate water resources to meet the needs of their customers. Without an incentive, selling companies would make no economic profit from water trades and would therefore have little motivation to trade. [1]

In our draft methodology,[2] we explained that while we intend to retain the current water trading incentive for PR24, we consider that it will need replacing in future. This is because schemes currently being developed through RAPID will allow for large-scale inter-company water trading that may significantly increase the volumes of water traded from 2030 onwards. We do not consider that the current incentive would be suitable for such schemes.

We also undertook to provide guidance on our future policy on the water trading incentive for PR24 and beyond. In doing so, our aim is to provide a greater degree of certainty for investment decisions which may be made in the coming years.

Our methodology applies to England and Wales. However, we note that trades between companies wholly or mainly in Wales and those wholly or mainly in England may be subject to distinct arrangements. Any new trades between Wales and England are subject to certain additional guiding principles, for example that the relevant company or companies must provide detailed analysis and explanation of the economic, environmental and multi benefits for Welsh citizens.[3] Different charging arrangements may also apply to cross-border trades.

The rest of the appendix is structured as follows:

- In Section 2 we set out our final methodology for PR24, which applies for water trades commencing prior to April 2030.
- In Section 3 we set out how we will adapt the current incentive which will apply to water trades commencing in the period 2030-35, and potentially beyond.

[1] We set companies' revenue controls on a 'single till' basis. This involves setting a revenue allowance under which companies recover their costs for the services they provide to customers from charges to end customers and charges for services provided to other companies, such as the provision of bulk supplies of water.
[2] Ofwat, 'Creating tomorrow, together: Consulting on our methodology for PR24', July 2022.
[3] Welsh Government, 'The Welsh Government Guiding Principles for Developing Water Resources Management Plans', 2022.

2. Water trading incentive for PR24

This section sets out our policy on the water trading incentive for PR24, which applies to new qualifying trades which commence in the period 2025-30.

2.1 Our final methodology policies

The current water trading incentive was introduced in PR14 and carried over into PR19. We will retain it at PR24. The water trading incentive in this form will apply to new qualifying trades which commence up until 31 March 2030.

2.2 Changes from our draft methodology

We are not making any changes from our draft methodology. We will maintain the water trading incentive in its current form for PR24.

2.3 Stakeholder views

Stakeholders either endorsed our intention to retain the current incentive for PR24 or did not directly comment on it.

2.4 Our final decisions and reasoning

We are retaining the water trading incentive in its current form for PR24. We reiterate how it works in this section.

We will allow exporters to retain 50% of the lifetime economic profits (that is, the profits over and above the normal return on capital invested)[4] for all new qualifying trades in 2025-30. We will calculate an export incentive payment as part of PR29. This will be equal to 50% of the full discounted economic profit for the forecast life of the export, with a cap of 100% of the economic profit for the years the export operates in 2025-2030. Any amount beyond the cap

[4] We provided a fuller description of economic profit in Ofwat, 'Delivering Water 2020: Our final methodology for the 2019 price review Appendix 5: Water resources control' (p. 53), December 2017: "Economic profit is the difference between revenue and costs, which include the return on capital invested. Lifetime economic profits are the sum of economic profit each year for the duration of the trade, discounted by the real cost of capital to reflect the time value of money. The reconciliation model used to claim the incentives is populated with an example that shows this. The incentive itself is paid through an uplift in allowed revenue in the next period, across the water resources and network plus controls. This is then collected from customers."

will be rolled forward to 2030-35 with the potential for a further export incentive payment at PR34.

We will allow importers to retain an import incentive of 5% of the costs of water imported for all new qualifying trades during 2025-30. All import incentive payments will be subject to a cap of 0.1% of the importer's wholesale water turnover in each year of the control period. The import incentive payments are accrued annually during 2025-2030, with the cap applying in each year. Importers will receive the import incentive payments at PR29.

Each company is required to show that their trades comply with their Ofwat-approved trading and procurement code. Our guidance on the trading and procurement code was published in May 2018.[5] We will republish the guidance with minor updates in early 2023. The code makes sure that only economically and environmentally beneficial trades will receive incentive payments.

Trades are assessed as part of our price review, and reflecting this, payments are claimed in subsequent price control periods. Trades which commence prior to 2030 will not be affected by our intention to change the trading incentive in 2030.[6]

The incentive payments will need to be allocated between the water resources and network plus water controls. This is because trades will utilise assets across both controls. As part of their business plans, we expect companies to propose an indicative split for future incentive payments between these controls.[7]

To claim incentives for new water trades that begin in 2020-2025, companies will have to submit their claim as part of their business plans for PR24. To submit a claim, companies will need to have a trading and procurement code approved before business plan submission. Where relevant, a company should submit:

- the water trading reconciliation rulebook model; and
- a short report setting out how the trades meet the criteria set out in its approved trading and procurement code. This should include an overview of the trade itself, which explains the assets used across the water resources and network plus water control. Justification should also be provided for the proposed split between the water resources and network plus water controls.

[5] Ofwat, 'Trading and procurement codes: guidance on requirements and principles', May 2018.
[6] Claims for new qualifying trades that begin in 2025-30 will be submitted as part of business plans for PR29, but will be unaffected by the intended change of the incentive for PR29.
[7] To assist this, we provided high-level guidance in Ofwat, 'Delivering Water 2020: Our final methodology for the 2019 price review Appendix 5: Water resources control' (Box 5, pp. 55-57), December 2017.

3. Water trading incentive from PR29

In the draft methodology, we set out our rationale for changing the way in which we incentivise water trading from PR29 onwards.

We noted that some future trades, such as those that might arise from the development of the RAPID strategic water resource solutions, may take a very different form from the types of trades that could be supported by the current incentive.[8] Further, we noted that such trades may underpin (in whole or part) the investment case for major capital expenditure, supported by long-term contracts that may cover several decades.

We also noted that while the investment in supporting infrastructure would be separately incentivised (either through delivery by direct procurement for customers (DPC),[9] for discrete infrastructure, or from returns on RCV), the nature of the trade itself is likely to have different features. There may be only limited confidence in ex-ante forecasts of traded volumes and profits for these contracts. Should an exporter retain its share of profits in the first half of the contract life (as with the current incentive) it would create an issue for inter-generational equity for its customers, who might not see any benefits for many decades.[10]

Finally, we noted that the trade (and the trading environment) may also evolve over its lifetime. For example, as more transfer options become available to companies, there may be more dynamism in operational decisions and a greater role for coordination in operations across companies.

In response to these anticipated changes and noting that projects commencing construction during the 2025-30 period would benefit from greater certainty about the form of trading incentive that would be in place for PR29, we consulted on whether to either adapt the current incentive or to introduce a new incentive.

3.1 Our proposal in the draft methodology

In our draft methodology we set out our preferred option of adapting the current incentive and an alternative option of introducing a new incentive adapted from an approach proposed by NERA in a consultancy report for RAPID.[11]

[8] We note, for example, that the incentive has already needed some significant adaptations in relation to the water trade that the Havant Thicket reservoir will enable.
[9] In certain cases, it may be that schemes are more suited to delivery via The Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013.
[10] In practice this means the company will retain the profits in the first half of the lifetime of the trade.
[11] NERA, 'Review of Bulk Supply Contracts and Pricing in the English & Welsh Water Sector', 16 December 2020.

In our preferred approach we said that we would retain the current incentive, subject to the changes summarised in Table 3.1 below.

Table 3.1: proposed changes in the adapted water trading incentive

	Current incentive	Proposed PR29 adapted incentive
Point of approval of incentive for trade	Assessment of business plans for the price control period following the commencement of trade (subject to trade being consistent with an approved trading and procurement code).	Aligned with the approval for investment that will facilitate the trade (subject to trade being consistent with an approved trading and procurement code).
Claiming revenues	In the price control period subsequent to the claim being made (and subject to a cap of 100% of the economic profit for the years the export operates within the price control period, with any amount beyond the cap rolled forward to the following price control period).	Claimed within period. A cap of 50% of economic profit may be retained in each reported year.
Import incentive	5% of the costs of water imported under qualifying trades, subject to a cap of 0.1% of the importer's wholesale water turnover in each year of the price control period. Incentive payments are accrued annually during the price control period, with the cap applying in each year. Incentive payments are claimed in the subsequent control period.	5% of the costs of water imported under qualifying trades, with no cap. Incentive payments are claimed annually during the price control period.

We noted that there is currently no prohibition on a company simultaneously benefitting from both import and export incentives and that we did not propose to change this.

In the alternative option we proposed that we would set the charge of each trade by undertaking a one-off assessment of the costs of the buyer's next best option, comparing with the costs of the trade, and from this estimating the economic rent and then setting the proportions that should accrue to buyer and seller.

3.2 Stakeholder responses to our proposals

Our proposal to provide early certainty that we would replace the current water trading incentive for PR29 and provide a clear steer on the form which the new incentive would take was broadly welcomed by stakeholders. All companies commented on this proposal, and we received some comments from other stakeholders, notably those with a direct interest in trading.

Almost all respondents who expressed a view agreed with our preferred approach of adapting the existing incentive. South West Water was the only stakeholder to express a preference for the alternative approach which we put forward.

Only a small number of stakeholders engaged with the specific changes that we proposed for the revised trading incentive which we would put in place from PR29.

Anglian Water, Northumbrian Water and Agilia welcomed our proposed modification to move forward the point of approval for trades, with Agilia suggesting that a "pre-approval" process might need to take place for some schemes during the 2025-30 period.

Five stakeholders commented on our proposed modification to claiming the incentive in-period based on actual costs, revenues and volumes. South Staffs Water, Wessex Water and Agilia supported the proposal, while two stakeholders, Northumbrian Water and Anglian Water, noted that making annual calculations could present challenges in terms of accurately allocating costs and revenues.

Five stakeholders[12] supported our proposal to consider raising or removing the cap on import incentive revenues that could be claimed. There was no consensus around how this should be done.

In terms of additional issues, United Utilities said that our guidance on bulk supply charging would need to be updated to make sure there is consistency with the water trading incentive. Northumbrian Water and Anglian Water were supportive of our view that we would not introduce a prohibition on companies from claiming both import and export incentives if they were in a position to do so (for example through having different supply/demand deficit positions in different water resource zones). Severn Trent Water/Hafren Dyfrdwy noted that it was unclear how multi party trading incentives would work, noting in particular the complexity of using river systems to effect transfers.

3.3 Our intentions for PR29

In the light of stakeholder feedback, it is our intention to proceed with our preferred option to introduce an adapted version of the current water trading incentive at PR29. This would apply to qualifying trades that are new from April 2030 onwards. The outline of how the incentive is intended to operate is set out overleaf.[13]

[12] Affinity Water, South Staffs Water, United Utilities, The All Company Working Group, and Agilia.
[13] We note that while we are setting out our intended approach here, our final approach will only be confirmed as part of the PR29 final methodology.

3.3.1 Summary of adapted water trading incentive applicable from PR29

For all new qualifying trades in 2030-35 we will allow exporters to retain 50% of economic profits (that is, the profits over and above the normal return on capital invested) within period.

For all new qualifying trades in 2030-35 we will allow importers to benefit from an import incentive of 5% of the costs of water imported annually with no cap. Incentive payments will be claimed annually during the price control period.

For a trade to qualify for the water trading incentive, it must comply with the company's trading and procurement code.[14] Companies may seek pre-approval for a trade to be eligible for the water trading incentive. This pre-approval may be granted alongside the approval for investment that will facilitate the trade. A company should provide a short report setting out how the trade meets the criteria set out in its approved trading and procurement code.

Incentive payments will need to be allocated between the water resources and network plus water controls.[15] This is because trades will utilise assets across both controls. When companies claim the incentive, we expect them to indicate the split of incentive payments between these controls.[16]

3.3.2 Other issues

We will republish the guidance for the trading and procurement code with minor updates in early 2023. Subsequently, we will set out further detail on arrangements for pre-applying for the adapted incentive which will come into effect at PR29. As a minimum, any pre-approval will depend upon a company having an approved trading and procurement code in place, the trade complying with the code, and approval of any required capital investment.

We note that some stakeholders raised concerns about the accounting complexities of claiming in-period incentive payments on an annual basis, noting for example that trades may relate to capacity reservation as well as volume. We are committed to the claiming of the incentive in-period as a means of protecting both current and future customers. However, we acknowledge that more granular accounting will bring greater complexity in some instances. Relevant charging rules for bulk supply sit outside of the price control, but will have a

[14] We must approve the company's trading and procurement code, which we do where we consider it complies with our code guidance. We note that the RAPID regulatory and commercial work stream will consider, amongst other things, the ways in which trading is governed. Without pre-judging the outcome of this work, companies will nevertheless still require Ofwat approval before being able to claim the water trading incentive. Any trade that companies wish to claim the water trading incentive for must comply with the relevant governance of trades.
[15] If relevant. We noted in the final methodology that we may reconsider the boundary of the water resources control for PR29.
[16] We will provide an updated water incentive reconciliation rulebook model and guidance at PR29 to assist companies.

significant impact on the water trading incentive. RAPID is taking forward work on bulk supply charges for strategic resource options. The scope of this work includes the recovery of both fixed costs (from which the importer may benefit from the availability of capacity) and variable costs (which correlates to the cost of delivering water). We also note that there are precedents that encompass trading incentives relating to both capacity and delivery.

As noted above, companies will be able to claim both import and export incentives where they have multiple trades. We will give further consideration to how the incentives should work for trades involving transit (where the same company imports and exports water to facilitate trade between two other companies). The appropriate approach may depend on the extent to which the transit company is involved – for example it would clearly be inappropriate for a transit company to get greater incentives than either the primary importer or exporter (by virtue of getting paid both incentives) if it only played a small role.

We have decided to remove the cap on the import incentive. We will instead undertake an ex-post evaluation for trades and where the incentives have been claimed in breach of the trading and procurement code (for example for a volume of imported water that is not economically and environmentally rational) it will be returned to customers via a claw back. We will keep this area of the incentive under review and may reintroduce caps in a future price review if we consider it to be in the interests of customers and the environment.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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